SECTION III

CURRENT ENVIRONMENT

INTRODUCTION TO THE CURRENT ENVIRONMENT

Purpose

The Department's financial management community has over 150 initiatives underway to improve and streamline financial management and improve the timeliness and accuracy of its accounting data. This places the Department in the midst of the most comprehensive reform of its financial management systems and practices in its history. These initiatives are driven by two pressing needs: (1) the need to overcome decades-old deficiencies in financial management systems and procedures and (2) the need to lower administrative costs by fundamentally redesigning the Department's fiscal operations.

Prior to January 1991, financial management within the Department was conducted independently within each Military Department and Defense Agency. As a result, each Military Department and Defense Agency developed its own processes and business practices tailored to its particular missions with little incentive to achieve compatibility with other departmental activities. As DoD missions became more complicated and organizations were required to interact more often with each other, the incompatibility of systems and lack of standardization often resulted in incomplete and inaccurate financial management data.

Various reports completed by the General Accounting Office (GAO), the Office of Management and Budget (OMB), and the Department of Defense Inspector General (DoDIG) identified weaknesses in the Department's financial management. Subsequently, reporting requirements mandated by the Congress and supported by the GAO required the Department to provide information related to current financial management processes and systems.

The Current Environment reports on the progress to date in achieving Department's finance and accounting goals and discusses current DoD roles and responsibilities and finance and accounting structure. This section also notes the present financial management status and identifies areas that require improvement. Finally, an analysis of current DoD financial management provides an assessment of the Department's current financial management status and identifies how the Department will move from its current environment to the future environment as laid out by the Concept of Operations (Concept).

ACHIEVEMENTS AND PROGRESS TO DATE

DoD Goals

In an effort to improve the Department's financial management and accounting data accuracy, the Department developed five financial management goals to serve as tools in setting priorities and measuring programmatic success. These goals seek to ensure that financial management better fulfills the needs of its leaders, meets statutory requirements, maximizes efficiency, minimizes opportunities for fraud, and provides outstanding customer service. These five goals are to:

- consolidate finance and accounting operations
- reduce the number of finance and accounting systems and improve their capabilities
- reengineer DoD business practices
- strengthen internal controls
- maintain a department-wide framework to provide for sound financial management

The Department has made significant progress toward achieving these goals.

DoD Achievements

In January 1991, the Department activated the DFAS by capitalizing the finance and accounting functions of the Army, the Navy, the Air Force, the Marine Corps, the Defense Logistics Agency (DLA), and other related organizations into a single DoD agency. The goal was to develop a single integrated financial management process that produces both reliable financial information for all levels of management and auditable financial statements.

Consolidated Finance and Accounting Operations

The Department completed the consolidation of its finance and accounting operations during FY1998. All of the original 332 DoD accounting sites were closed and their work consolidated into 19 DFAS operating locations (OPLOC) (reduced from the original 21 OPLOC sites) and five DFAS centers. With this consolidation, savings are expected to total $120 million per year.

Reduce and Improve Finance and Accounting Systems

As shown in Figure III.1, the Department reduced the number of critical finance and accounting systems from 324 in FY1991 to 109, as of September 1998 (91 accounting systems and 18 finance systems). This represents a 66 percent reduction from the FY1991 baseline. The goal is to reach a total of 32 systems by FY2003. An inventory of critical finance, accounting, and feeder systems is located in Appendix B of this volume.

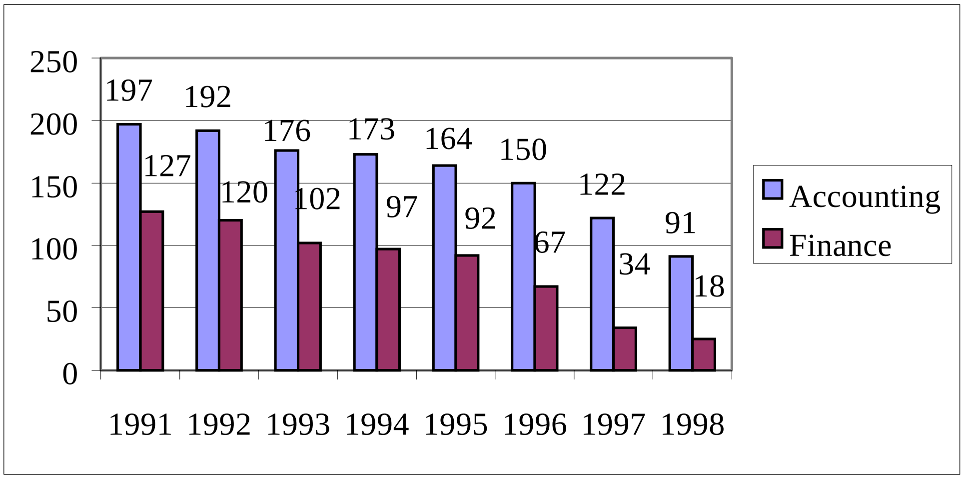


Figure III.1 Reduction in DoD Finance and Accounting Systems FY1991-FY1998

An example of system consolidation is the Defense Retiree and Annuitant Pay System (DRAS). The Department consolidated eight systems for retiree and annuitant pay operations into this one standard system, resulting in a cost reduction of $10 million per year.

To improve the Department's finance and accounting systems, the Department established a Year 2000 (Y2K) project in 1991. This project has the responsibility to monitor and track all Y2K non-compliant financial management systems. Tasks and milestones were assigned to make the Department Y2K compliant.

Reengineer DoD Business Practices

A critical aspect of the Department's financial management reform is the reengineering of its business practices, which are the procedures by which management and administrative systems function. The goal is to make DoD business practices simpler, more efficient and less prone to error through the Commercial Activities Program, the implementation of most efficient organizations (MEO), the reduction in the volume of financial management regulations, and the implementation of a government-wide purchase card.

The Department also began a full and active OMB Circular A-76 Commercial Activities Program by initiating two studies in the areas of debt and claims management and facilities, logistics and administration.

During FY1996, the Debt and Claims Management study was completed resulting in the implementation of the Federal Government's MEO. This MEO, which was fully implemented in May 1997, consolidated the debt and claims management functions at the Denver Center, and resulted in annual savings of over $8.5 million.

The Facilities, Logistics, and Administration study, completed in May 1997, also resulted in the implementation of a government MEO. This MEO, which was fully implemented at the beginning of FY1998, will produce an annual savings of over $4 million.

The Department took steps to reduce the volume of financial management regulations by publishing the Financial Management Regulation (FMR). The DoD FMR replaces approximately 70,000 pages of separate DoD organizational regulations. All 15 volumes of the FMR are available on the Internet. Hard copies are no longer issued, however, paper and CD-ROM copies of the volumes can be ordered through the FMR site on the Internet.

The government-wide purchase card, known as the International Merchant Purchase Authorization Card (IMPAC), is one of the Department's major efforts in business process reengineering. It allows the individual cardholder to purchase items or services under $2,500. Vendors are reimbursed for these purchases by an authorized commercial bank, to which the Department makes consolidated payments. Implementation of this card is an achievement in streamlining the acquisition process and cutting the costs of performing finance and accounting support for the processing of commercial invoices.

A problem disbursement occurs when an expenditure has not been reconciled with official accounting records. In June 1993, when the Department began intense efforts to resolve these situations, the Department had a total of $34.3 billion in negative unliquidated obligations (NULO), unmatched disbursements (UMD), and in-transit disbursements (INTRANST). In February 1997, the Department established a new office to focus and direct DoD-wide efforts to identify the types of disbursement transactions resulting in UMDs, INTRANSTs, and NULOs, isolate causes and reasons, and develop viable alternatives for reducing and eliminating the underlying conditions. By August 1997, the inventory of UMD/NULO/INTRANST was reduced to $8.2 billion in absolute NULO/UMDs and $4.2 billion in net INTRANSTs.

Strengthen Internal Controls

The Department implements checks, balances, and approval requirements for transactions that affect resources. Internal controls minimize the Department's susceptibility to fraud, waste, abuse, and mismanagement within its finance and accounting operations. The Department strives to incorporate the appropriate levels of verification without requiring excessive resources or hampering the ability to complete the mission.

Operation Mongoose is an example of strengthened internal controls within the Department that detect and prevent fraud. The program was established in 1994 and includes the combined team efforts of the DFAS, the Defense Manpower Data Center (DMDC) in Monterey, CA, and the DoDIG Office, including the Defense Criminal Investigative Service (DCIS). These three organizations are working together to develop fraud indicators that are generated by discrepancies between systems. They collect and compare data from all over the Department, detect the presence of anomalies within DoD systems, examine the appropriate records to determine if the anomalies actually are a result of fraud, and pursue criminal charges against those responsible for the fraud. The objective is to establish a permanently structured organization that will detect and prevent fraud by actively seeking it out, rather than waiting for it to surface by chance, be identified by informants, or be detected by random reviews that allow too great an opportunity for concealment of the crime. Several functional areas are included in fraud investigations:

- retiree and annuitant pay
- military pay
- civilian pay
- vendor pay
- transportation pay

Maintain a Framework

The Department has reorganized the way it operates its finance and accounting. In 1991, the DFAS was established to reduce the cost and improve the overall quality of DoD financial management through consolidation, standardization, and integration of finance and accounting procedures, operations, and systems.

The finance and accounting functions were divided between the DFAS and the Military Departments and the Defense Agencies. The DFAS processes transactions and prepares the financial statements. The Military Departments and the Defense Agencies retained certain primary level, programmatic finance and accounting functions, as they are best performed at the installation and agency level.

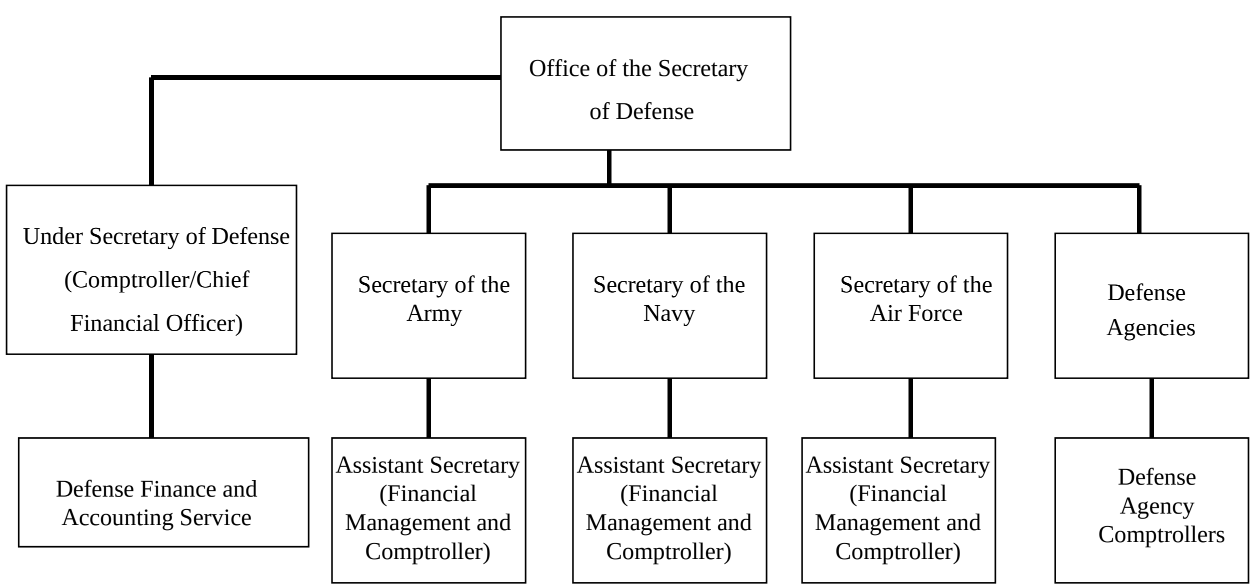
A management oversight structure was constructed to ensure the involvement of the Department's senior leaders in the financial improvement process. This structure includes a DoD Financial Management Steering Committee and a Working Capital Funds Policy Board. These entities are actively engaged in approving and monitoring the Department's financial management reform efforts.

ROLES AND RESPONSIBILITIES

Over the past several years, the Department's finance and accounting organization and management structure underwent major changes. Significantly, the DFAS, the Military Departments, and the Defense Agencies now share the finance and accounting responsibilities that previously belonged only to the Military Departments and the Defense Agencies.

Organization and Management

As illustrated in Figure III.2, two chains of command within the Department perform finance and accounting operations. On one side is the DFAS, which reports to the USD(C) within the Office of the Secretary of Defense. On the other side are the Military Departments, headed by their respective Secretary, and the Defense Agencies, led by their respective Director. Each Military Department Secretary has an Assistant Secretary (Financial Management and Comptroller) who directs and manages financial management activities consistent with policies prescribed by the USD(C) and the Military Department's implementing directives. Each Defense Agency has a Comptroller whose responsibilities are similar.



Note: There are a number of additional offices at the Under Secretary of Defense level. This chart shows only the high-level relationship between the Secretary of Defense and the DFAS, the Military Departments, and the Defense Agencies.

Figure III.2 Relationship between the Secretary of Defense and the DFAS, the Military Departments, and the Defense Agencies

Under Secretary of Defense (Comptroller)

The USD(C) is the principal advisor and assistant to the Secretary and Deputy Secretary of Defense for budgetary and fiscal matters (including financial management, accounting policy and systems, budget formulation and execution, and contract audit administration and organization), DoD program analysis and evaluation, and general management improvement programs.

The National Defense Authorization Act for Fiscal Year 1994 designated the USD(C) as the Department's Chief Financial Officer (CFO). Specific duties of the USD(C)/CFO as specified in the Chief Financial Officers Act include:

- interpreting, augmenting and promulgating financial management laws, regulation, and guidance within the Department
- directing, managing, and providing policy guidance and oversight of agency financial management personnel, activities, and operations
- developing and maintaining integrated accounting and financial management systems
- monitoring the financial execution of the agency budgets in relation to actual expenditures, and preparing and submitting timely performance reports
- overseeing the recruitment, selection, and training of personnel to carry out agency financial management functions

The USD(C) has no direct line of authority over any of the financial management staff within the Military Departments, the Defense Agencies, or DoD field activities. They report through their own organizational structure to their respective unit heads. The USD(C) and the unit heads report to the Secretary of Defense. The USD(C), however, does issue policies, instructions, regulations, and procedures relating to financial management matters and the production of financial statements, which are binding on all DoD activities.

DFAS

The DFAS was activated on January 15, 1991, to reduce the cost and improve the overall quality of DoD financial management through consolidation, standardization, and integration of finance and accounting procedures, operations, and systems. The DFAS is responsible for identifying and implementing finance and accounting requirements, systems, and functions for appropriated and non-appropriated funds, as well as working capital funds, revolving funds, and trust fund activities, including Security Assistance.

In December 1992, the DFAS assumed responsibility for all finance and accounting operations and the associated 332 installation finance and accounting offices nationwide and began to consolidate. As of mid-1998, the DFAS consists of a headquarters located in Arlington, Virginia, with five centers located in Cleveland, Ohio; Columbus, Ohio; Denver, Colorado;

Indianapolis, Indiana; and Kansas City, Missouri; and 19 OPLOCs located nationwide, as shown in Figure III.3.

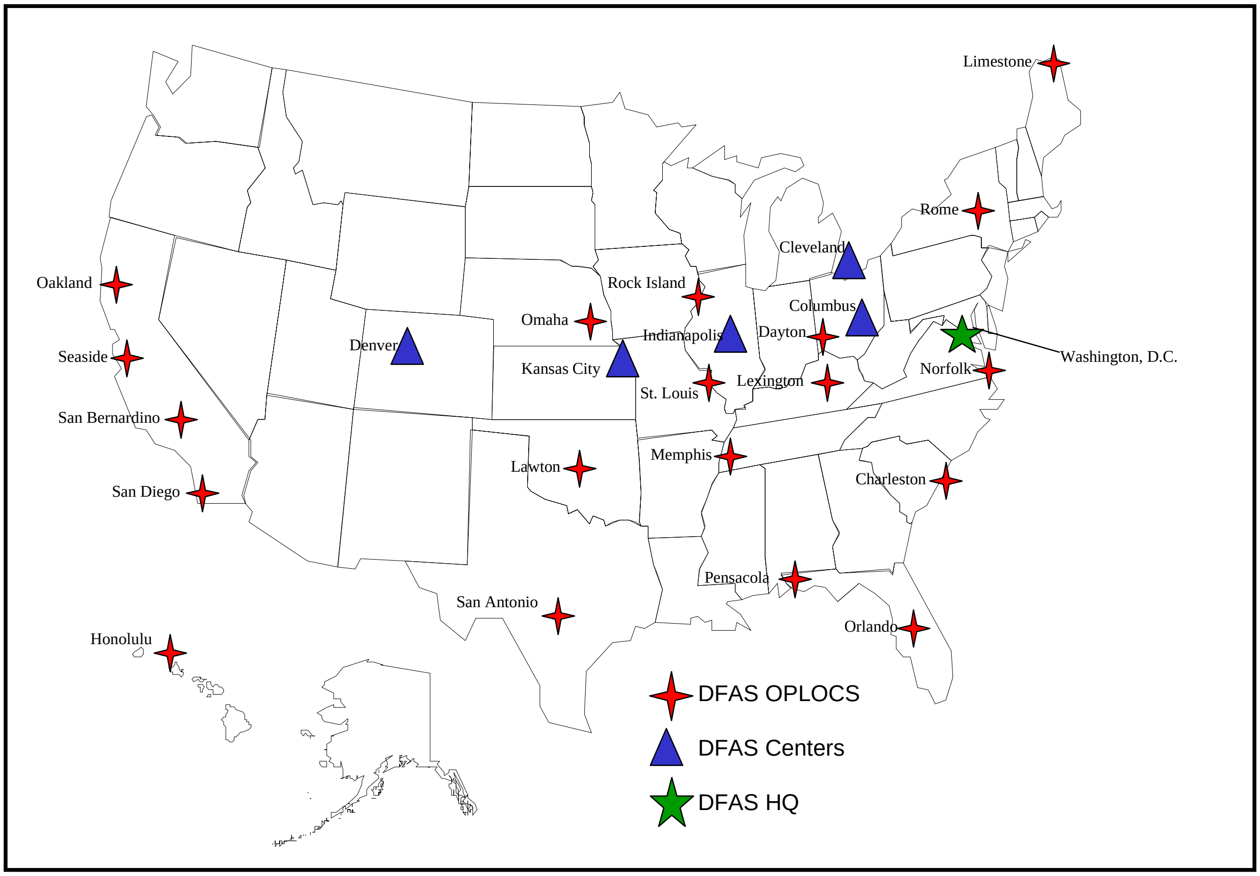


Figure III.3 Current DFAS Locations

Military Departments and the Defense Agencies

Each Military Department has an Assistant Secretary for Financial Management and Comptroller who reports to the Service Secretary and directs and manages financial management activities consistent with policies prescribed by the USD(C)/CFO and the Military Department's implementing directives. The Assistant Secretary for Financial Management and Comptroller position in each Military Department was established in the National Defense Authorization Act for Fiscal Year 1989. This act delineated many of the responsibilities of the office, including:

- managing financial management activities and operations
- directing the preparation of budget estimates
- approving any asset management systems, including cash and credit management
- collecting debts
- accounting for property and inventory systems

Each Defense Agency has a comptroller who directs and manages financial management activities consistent with policies prescribed by the USD(C)/CFO.

With the establishment of the DFAS, financial management functions were divided between the Military Departments and the Defense Agencies and the DFAS. The division resulted in certain primary-level, programmatic financial functions remaining with the Military Departments and the Defense Agencies.

DoD Management Oversight Structure

The Department is using a management oversight structure to ensure the involvement of the Department's senior leaders in the financial improvement process. This includes the DoD Financial Management Steering Committee and the Working Capital Funds Policy Board (Policy Board). These entities are actively engaged in approving and monitoring the Department's financial management reform efforts.

The DoD Financial Management Steering Committee oversees the development of the functional requirements for general fund financial and accounting systems, facilitates the implementation of policy recommendations, and addresses financial management systems and practices. The Committee is chaired by the USD(C) and includes:

- the DFAS Director
- Assistant Secretaries (Financial Management and Comptroller) of the three Military Departments
- Comptroller of the DLA
- a senior official from the Office of the Assistant Secretary of Defense (Command, Control, Communications, and Intelligence) (ASD (C3I))

The Policy Board monitors the implementation and operation of the working capital funds, including policies, rates, cash flow analysis, and the criteria for inclusion of business areas therein. The Policy Board is chaired by the USD(C) and includes the Assistant Secretaries (Financial Management and Comptroller) of the three Military Departments and:

- representatives from the Joint Chiefs of Staff
- the USD (Personnel & Readiness)
- the ASD (C3I)
- the Director of the DFAS

The DoDIG is a special observer to the Policy Board. Overarching policies, procedures and reporting guidance for working capital fund activities were formally incorporated into the DoD FMR and published in December 1994. Three sub-committees, Oversight of Policy Actions, Cost Reductions, and

Performance Review, were established to develop recommendations and to review recommendations submitted to the Policy Board.

The Army General and Mission Equipment Working Group – CFO Compliance is a joint working group that includes key Army and DFAS representation. This group works to ensure successful and accurate reporting of general and mission equipment in the Army. It is determining key elements, possible approaches and solutions for meeting existing and future reporting requirements for Army equipment, as well as changes in systems to meet equipment reporting requirements.

The Senior Level Steering Group (SLSG) was created in FY1993 as a direct result of the internal audits of the Army's financial statements prepared under the Chief Financial Officers (CFO) Act. It is composed of the principal deputies of the Army Staff and Secretariat. The Group's mission is to address issues raised by the auditors and develop approaches to meet the requirements of the CFO Act. In addition, the Group's responsibilities have been expanded in recent years to include acting as the Secretary of the Army's corporate review board for his annual statement of assurance on management controls, and for the review of selected and potential Army-level material weaknesses.

The Real Property Integrated Process Team (RP-IPT)-CFO Compliance is a joint working group that includes key Army and DFAS representation to assist in ensuring the successful and accurate reporting of land, buildings, and structures. The RP-IPT determines approaches and solutions for meeting existing and future reporting requirements for the Army's real property. Specific issues addressed by the RP-IPT include:

- overall issues of accounting for and reporting of the Army's investment in land, buildings, and structures
- determining how to apply definitions for Stewardship Reporting
- identifying data sources to quantify and value the Army's investment in land, buildings, and structures

The team is currently in the process of determining and implementing changes needed to existing systems to meet the reporting requirements for real property.

FINANCE AND ACCOUNTING STRUCTURE

Operational Structure

The Department's current finance and accounting structure is split between the Military Departments and the Defense Agencies, and the Department's primary financial accounting organization, the DFAS. The primary or source level financial management data originates with the Military Departments and the Defense Agencies. This data is then fed to the DFAS where the data is processed in the Department's financial and accounting systems.

As the Department's financial management service organization, the DFAS processes transactions and prepares the financial statements. The DFAS charges each Military Department and Defense Agency a fee for its services.

The Military Departments and the Defense Agencies are responsible for providing the DFAS with source finance and accounting data. Operational commanders and program managers acquiring, managing, allocating, transporting, using, or disposing of DoD resources generate this source data, called program events. The Military Departments and the Defense Agencies own and operate the program feeder systems that feed program event data to the DFAS. The DFAS then processes the data and provides commanders and managers, at all levels, the financial information they need to make informed financial decisions, meet reporting requirements, and maintain the general ledger.

DFAS Functions

The DFAS is organized to perform the Department's basic finance and accounting operations. Finance operations include the processing of payments to DoD personnel, retirees, annuitants, and contractors. Accounting operations record, report, and analyze financial activity.

Finance Functions

Currently, the DFAS performs the following nine financial activities, primarily focusing upon payment operations.

1. <u>Military Pay</u> is the payment of uniformed men and women.
2. <u>Retiree and Annuitant Pay</u> is the payment of military retirees and dependants.
3. <u>Civilian Pay</u> is the payment of DoD civilian employees.
4. <u>Vendor Pay</u> is the payment of commercial invoices, except for centrally managed contracts.
5. <u>Travel Pay</u> is the payment for official duty travel.
6. <u>Debt Management</u> is the collection of debts from individuals and contractors.
7. <u>Disbursing</u> releases monies for various types of functions.

8. Contract Pay is the payment to DoD contractors for goods or services rendered against centrally managed contracts.
9. Transportation Pay is the payment for government bills of lading and transportation requests.

Accounting Functions

Accounting functions currently consist of six activities.

1. Working Capital Fund activities operating in a business-like environment where the customer requiring the support pays for services or products on a unit-cost basis.
2. General Fund supports the management of funds appropriated by the Congress to perform the Department's missions.
3. Cash Accountability records, manages, and reports DoD expenditures to the Department of the U.S. Treasury. Cash accountability information is updated by accounting, pay, and disbursing systems.
4. Departmental Reporting consolidates budget execution, expenditure, and general ledger information from the Defense Working Capital Fund and General Fund accounting systems to produce fiduciary and managerial reports for the U.S. Treasury, the OSD, the OMB, the Military Departments, the Defense Agencies, and other federal agencies.
5. Foreign Military Sales provide accounting support to activities that sell military equipment, weapons, technology, and training to foreign governments based on agreements with the United States.
6. Non-Appropriated Funds support revenue-generating morale and welfare activities for the Military Departments and the Defense Agencies, such as officer and enlisted clubs, hobby shops, and billeting funds. These activities operate like a private-sector business and are supported by user fees.

The Military Departments and the Defense Agencies

With the establishment of the DFAS as the Department's financial service organization, the Military Departments and the Defense Agencies generally no longer perform core finance and accounting functions at the installation and agency level. However, the Military Departments and the Defense Agencies did retain managerial accounting responsibilities to provide oversight, validation, and review of the following functions to support the activity commanders, agency directors, and the DFAS OPLOCs.

- Reviewing and computing travel claims prior to forwarding them to the operating locations
- Assisting the OPLOCs with follow-up on problem transactions
- Distributing funds
- Providing data electronically and forwarding documents to the OPLOCs
- Preparing and processing collection vouchers for checks and cash received locally

- Reconciling funding document differences
- Printing hard copy reports as required
- Processing receiving reports
- Approving travel obligations
- Providing military pay customer service
- Providing cash support for contingency operations
- Inputting civilian and military pay transactions
- Interpreting accounting reports for the installation
- Monitoring legal limitations
- Inputting accounting transactions (i.e., commitments, earnings, funds, inventory transfers, real property transfers, and obligations)

Technical Supporting Structure

The DFAS maintains the core systems required for finance and accounting. Each of the five DFAS centers is responsible for supporting certain functions and the systems required to support those functions. Multiple systems are used to perform the majority of finance and accounting functions, though some functions are performed from one system. For example, the vendor pay function is performed at multiple DFAS locations using multiple Service-specific systems, while DFAS-Cleveland performs the retired pay function and uses one system to support this function.

The Military Departments and the Defense Agencies maintain their own program systems to support their respective missions, though not all program systems contain source-level financial management information. Program systems that contain information necessary for financial management are considered program feeder systems. These program feeder systems send finance and accounting information to DFAS systems through real-time, electronic, or manual interfacing. The optimal type of system interfacing is real-time, where source data is entered into a relational database and available in the format needed virtually immediately to all other users of the database. The majority of feeder system data, however, is not entered into a relational database but transmitted by electronic or manual interface.

Electronic interfacing entails downloading the information during the transaction process into a file in a standard data format, to be sent electronically or via floppy disk to the next user, where it is uploaded and opened. This process is slower than real-time, as this process occurs only at the user’s discretion when he or she creates the batch file and sends it to the next user (often only once at the end of the day). This type of process must occur every time data is passed from one user to the next.
Manual interfacing requires the user at the source level to manually write down information to be passed to the next user and entered into the finance and accounting system. This type of interfacing is most susceptible to errors, may lack an adequate audit trail, and is least reliable of the three.

The Military Departments and the Defense Agencies input source documents into a feeder system. The data is batch processed into a file at the end of day one and sent via electronic transfer to a transaction processing system where data is verified and matched against records. Transactions are then batch processed at the end of day two and sent through a prevalidation process with the accounting system to verify funds availability. If funding is prevalidated, they are batch processed again and sent at the end of the third day back to the transaction processing to be recorded. Once recorded, transactions are batch processed and sent to the disbursing system to be recorded and paid. Another batch file is created and sent to the accounting system to create an accrual and record it.

The Department is currently employing technological improvements, which include some electronic commerce and electronic data interchange (EC/EDI). The benefit of using EDI is one-time data entry, which minimizes the opportunity for data error. The benefit of EC is that it provides prompt payment to vendors and reduces the amount of paper used. Organizations throughout the Department are in different stages of implementation of EC/EDI.

The Department is also using electronic funds transfer (EFT). Currently, over 90 percent of DoD civilian employees and military personnel have their pay directly deposited into their accounts through EFT. The DFAS is also implementing EFT in its vendor pay systems.

FINANCIAL MANAGEMENT STATUS

Scope

The Department is aware of the areas in which it must improve to achieve efficient and effective financial management and has pursued various activities to do so. Specifically, the Department is concentrating on eliminating the impediments to achieving auditable financial statements.

Status of Impediments to Auditable Financial Statements

Impediments to producing financial statements are grouped in these four problem areas:

- inadequate program feeder systems,
- inadequate core systems
- internal environment
- external environment

Inadequacies in the Program Feeder Area

The main issues under the program feeder area concern:

- program feeder systems
- inventory
- property, plant, and equipment (PP&E)

Program Feeder Systems

The Department faces several impediments to auditable financial statements because of its program feeder systems. These impediments include the following:

- program feeder systems are not modernized
- data discrepancies exist between the feeder systems and the core systems that capture program data
- program feeder systems lack common data elements

Program feeder systems were not originally designed to record or transmit all of the data elements needed by financial management systems to properly account for the Department's property and assist financial managers in managing costs. Therefore, discrepancies exist between data in the feeder systems and data in the core systems. As an estimated 80 percent of the data needed for financial management come from program systems, the use of modern, fully-integrated, and fully-interfaced program feeder systems is necessary for the Department to be able to provide its managers with the information they need to make informed decisions. The current use of a variety of non-integrated databases precludes the easy or reliable interfacing of information from program functional areas (i.e., personnel, acquisition, and logistics) with the Department's core finance and accounting systems. Additionally, these systems often are not sufficiently flexible to respond rapidly to changing customer bases, legislative changes, contingency operations, management initiatives, or requirements from other government agencies.

The future architecture of the Department's target financial management systems, as described in the Concept of Operations and detailed in the initiatives of Volume II, is designed with the requirements for modernized technology, standardized data elements, and real-time interfaces. This design will facilitate the effective and efficient transmitting of data between program feeder systems and core financial management systems.

Inventory

The Department faces several impediments to auditable financial statements because of problems with inventory. These impediments include the following:

- inventory valued at selling price and not historical cost
- problems with inventory account classifications
- disagreement as to when operating materials and supplies are issued to the end user
- how ammunition and munitions are categorized

An important aspect of the Department's financial management operations is the ability to consistently value and reconcile inventory to financial account balances. Current accounting standards require the Department to report inventory at historical cost or at latest acquisition cost if adjusted by an allowance for unrealized gains and losses to approximate historical cost. The Department's inventory systems do neither. Instead, the Department's inventory systems value assets at standard (selling) price. Additionally, inventory values are not included in DoD financial systems, but in logistical inventory systems. As a consequence, the dollar value of inventory reported on financial statements is a calculated amount, not a system-driven amount. These calculated amounts are determined using a computational formula that adjusts logistical inventory values to an approximation of historical cost and latest acquisition cost.

There is a difference of opinion regarding when operating material or supply is issued to end users. The Statement of Federal Financial Accounting Standards (SFFAS) No. 3, "Accounting for Inventory and Related Property," states that the consumption method of accounting for the recognition of expenses shall be applied for operating materials and supplies. The consumption method requires federal agencies to account for its operating materials and supplies as an asset until such time as they are issued to an end user for consumption.

Alternatively, the Standard states that the purchases method specifies applied to operating materials and supplies. The purchases method provides that operating materials and supplies be expensed when purchased. The purchases method may be used if (1) operating materials and supplies are not significant amounts, (2) they are in the hands of the end user for use in normal operations, or (3) it is not cost-beneficial to apply the consumption method of accounting.

Categorizing ammunition and munitions as operating materials and supplies under SFFAS No. 3, could require the Department to record an expense when ammunition and munitions are consumed. The Department does not have the processes or systems capable of reporting such expenses on a consumption basis.

PP&E

The Department faces several impediments to auditable financial statements as a result of problems with PP&E. These impediments include the following:

- the value of general PP&E is not recorded at historical cost
- information concerning quantities and condition of national defense PP&E is not maintained in financial systems but in logistical systems; in addition, supporting documentation for historical cost of national defense PP&E is not available
- the value of government property in possession of contractors is not captured
- the values of equipment and real property owned by field units and installations are not captured
- unserviceable equipment awaiting repair is not valued properly

The accounting standard for the recording of general PP&E requires that (1) it be recorded at historical cost and depreciated, (2) costs necessary to bring the assets into a fully operational condition shall be included in the recorded cost, and (3) when the historical cost of existing general PP&E assets is not available, estimates are to be used. The Department’s accounting systems were not designed to capture, retain, and depreciate the costs of PP&E assets.

The Exposure Draft amending SFFAS No. 6 and No. 8, requires the reporting of quantities, condition, and funding trends of national defense PP&E (e.g. weapons systems). An additional requirement proposed for comment by respondents to the Exposure Draft requires the reporting of the acquisition (historical) costs of national defense PP&E assets. Information concerning quantities and condition of PP&E is not maintained in financial systems but in logistical systems. Though difficult to obtain, this information is available. However, if historical acquisition costs were required to be reported, most costs would be estimated because supporting documentation is not available. The Department has approximately $92 billion in government furnished property in the hands of contractors. The Federal Acquisition Regulation

(FAR) requires contractors to maintain records for all government furnished property in their possession and property acquired by contractors for the Department, and to provide this information to the Department. The FAR also precludes federal agencies from keeping duplicate records, therefore the Department is dependent upon contractors for providing this information.

SFFAS No. 6 requires that all PP&E assets be recorded. The Department recognizes that its PP&E accountability and control systems are not 100 percent accurate. However, the errors that typically are identified relate to assets that have been disposed of or are not in active use.

The cost of deferred maintenance for PP&E must be reported in a footnote to the Statement of Net Cost. This is a new standard that is effective with FY1998. The Department does not have automated systems to capture and report deferred maintenance estimates that can be tied back to specific PP&E assets such as aircraft, tanks, and ships.

The Department selected the Defense Property Accountability System (DPAS) and is deploying it as an integrated property system. The DPAS provides for financial control over real and personal property and will replace over 150 separate property systems in the Department.

Deploying the DPAS DoD-wide will remedy such impediments to auditable financial statements as:

- valuation of government property in the possession of contractors
- valuation problems of unit and installation property
- valuation problems of equipment awaiting repair

Inadequacies in the Core Systems Area

The main issues under the core systems area include inadequacies in the following:

- core systems
- general ledger
- future liabilities
- U.S. Treasury fund balances
- intragovernmental eliminations

Core Systems

Properly accounting for billions of dollars of basic transactions is necessary to produce auditable government-wide financial statements. However, it is hindered by the Department’s inability to ensure complete and valid data is transmitted from program feeder systems to core financial management systems because of:

- the use of a variety of non-integrated data bases
- the lack of flexibility in the coding structure of the old hardware and software technology to respond to changing requirements
- improperly captured and reported data by existing processes and systems

Several impediments affect the Department's core financial management systems. First, because of the use of a variety of non-integrated databases throughout the Department, discrepancies exist in the data between the feeder system and the core system into which data is fed. Undocumented audit trails are also an outcome of non-integrated databases. Current systems were not designed to identify where source data originated. Because manual data-entry is often performed, an automatic audit trail is not recorded, sometimes leaving financial managers without an audit trail to follow. Second, the lack of flexibility in the coding structure of the old hardware and software technology make it difficult for the Department to respond to changing financial management requirements. Last, inadequate existing processes and systems are the cause of improperly captured and reported financial statement data.

The future architecture of the Department's target financial management systems, as described in the Concept of Operations, is designed to require the use of modernized, real-time databases. This will assist in eliminating data discrepancies and undocumented audit trails, as well as provide greater flexibility in response to changes in financial management requirements. Internal controls regarding processes will be also improved to correctly capture and report financial statement data.

General Ledger

The Office of Management and Budget (OMB) requires federal agencies to implement the U.S. Standard General Ledger (U.S. SGL) in their financial systems. The U.S. SGL, which is maintained, updated, and published by the Department of the Treasury, must be implemented by federal agencies at the transaction level. Agencies are permitted to supplement their application of the U.S. SGL to meet agency-specific information requirements. However, agency SGLs must maintain consistency with the U.S. SGL. DoD finance and accounting systems lack a single, standard, transaction-driven general ledger, as the U.S. SGL is not fully implemented throughout systems. The Department has mandated the implementation of the U.S. SGL and processing of transactions in accordance with SGL transaction rules in its financial management systems.

Future Liabilities

The Department faces several impediments to auditable financial statements because certain of the Department's future liabilities have not been accurately assessed. These liabilities include:

- disposal of assets and environmental clean-up

- post-retirement health care benefits
- progress payments, liabilities, and advances and prepayments

Determining the future cost of liabilities through the use of current costs instead of budget obligations and including all potential liabilities in the calculation, are necessary to provide accurate estimates. The Department is establishing policy and procedures to estimate the expected disposal costs for major weapons systems such as aircraft, missiles, ships, submarines, and ammunition. The DoD FMR is being revised to incorporate specific guidance that clearly identifies the requirement for managers, at all levels, to recognize estimated environmental liabilities

In reporting the actuarial liability for military post-retirement health benefits and claims, historically the Department based these claims on funds that were obligated. The Department recognizes deficiencies in the reporting of the actuarial liability for military post-retirement health benefits and claims.

Progress payments are required to be recorded as assets for construction in progress. Any unpaid contractor costs are to be recorded as liabilities, referred to as contract holdbacks. The audit community has indicated that the Department should treat all financing payments, not just those based on the percentage of completion, as construction in progress and record liabilities. However, progress payments based upon percentage of completion represent only one type of contract financing payment the Department is authorized to make. Other financing payments are also used as a means of providing contractors financing prior to the delivery of goods under fixed-price contracts. For most fixed-price contracts, for which financing payments are issued, the Department becomes liable only when goods are delivered in conformance with the contract terms. The Department is not liable for costs that the contractor has incurred at the time financing payments are issued.

U.S. Treasury Fund Balances

The Department faces impediments to auditable financial statements because of problems with its U.S. Treasury fund balances. These impediments include the following:

- differences in the DoD U.S. Treasury fund balance and with the balance accounted for by the U.S. Treasury
- differences in the DoD fund balance with the U.S. Treasury among DoD installations and headquarter activities

Appropriation cash balances on the books of the U.S. Treasury must reconcile with appropriation cash balances on the Department's books. For all appropriations, the DFAS Cleveland, Denver, and Indianapolis Centers electronically transmit monthly collection and disbursement data to the U.S. Treasury. In addition, other agencies that collect and disburse funds for the

Department also report these amounts to the U.S. Treasury. The U.S. Treasury provides the Department with monthly and annual reports that show the U.S. Treasury's fund balance with the U.S. Treasury account balance, which is the net amount. Currently, the Department reports the amounts reported by the U.S. Treasury instead of the balance reflected in the Department's financial records on its financial statements.

Frequently, the account balances at the U.S. Treasury do not agree with the account balances on the Department's financial records. These differences are caused primarily by three items: (1) the separate accounting and reporting systems, (2) errors in the preparation and perpetuation of financial information, and (3) the DoD collection and payment process. The Department will ensure that on a monthly basis, cash balance differences between U.S. Treasury and Agency records are identified, reconciled, and corrective action initiated. The Department will continue its efforts to minimize the use of suspense accounts, ensure the supportability of suspense account balances, and ensure charges/collections to suspense accounts are being reversed and posted to the correct accounts in a timely manner.

Cash balances on the financial records of the Department installations must reconcile with the summary cash balances on the financial records of the headquarters. Fund balances for appropriations and changes thereto, along with the corresponding U.S. Treasury accounts, are maintained in the financial records of installations and headquarters. The headquarters fund balance is a summary of the various installations. The installation financial data is summarized monthly and forwarded to the headquarters level for financial reporting. Monthly reconciliations between the installation maintained accounts and the headquarters level accounts should be performed but are not always reconciled. When performed, the installation fund balances do not always agree with the account balances at the headquarters level. Therefore, the balance on the monthly financial statements is not fully supported by the detailed financial records. The imbalances are primarily caused by three reasons: (1) the variety of non-integrated databases in use preclude the easy and reliable integration or interfacing of information from other financial systems; (2) the process of transferring documents among the various financial activities creates problems such as timing differences in posting transactions to the DoD financial records as well as misplaced documents; and (3) errors in the preparation and perpetuation of financial information.

To improve this process in the long-term, the Department plans to better integrate disbursing and accounting systems and require periodic reconciliations of the installation-level and headquarters-level funds with the U.S. Treasury account balances. The gradual lowering of the prevalidation limit reduced the level of differences in cash balances between Department headquarters and the installations. Continual lowering of the prevalidation limit and its expansion to all disbursing stations will enhance its effectiveness.

The Department will continue its efforts to work with the Military Departments and the Defense Agencies to reduce the amount of unmatched disbursements (UMD), negative unliquidated obligations (NULO), and intransits. In August 1997, the Department had approximately $8.2 billion in UMDs and NULOs and $4.2 billion in net intransits. Work-arounds and identification of causes at the "up front" stage will greatly reduce the number of new UMDs. The Department intends to educate and enforce the standards concerning monthly reconciliations. DFAS Centers must follow-up aggressively to ensure proper and timely reconciliations are completed. Out-of-balance conditions identified during the reconciliation process need to be fully documented and journal vouchers made as necessary to ensure supported general ledgers exist to document the financial statements.

Intra-governmental Eliminations

The Department faces impediments to auditable financial statements because of problems with its intragovernmental eliminations. These impediments include the following:

- verification of reported reconciliations of elimination amounts and materiality level
- reporting accounts payable, expenses, and disbursements
- reporting method and organizational reporting level

Federal agencies may be required to verify the reported reconciliation of elimination amounts between agencies. Currently, there is no guidance concerning this issue. If required, this standard would represent a very large workload for the Department.

In reporting accounts payable, expenses, and disbursements from other federal agencies, there are no standard Federal Government-wide policies, procedures, or processes. As a result, the Department does not routinely receive accrual data prior to the receipt of goods or services. The Department's accounting systems were not designed to aggregate accounts payable and expense data for individual providers of the goods and services.

Government-wide policies for FY1998 and FY1999 have not been issued that would require federal agencies to report elimination amounts at the agency, bureau, or fund symbol level. However, the current U.S. SGL structure does not provide for reporting amounts at this level of detail. Therefore, the use of the current U.S. SGL accounts will not permit elimination amounts to be reconciled accurately to the corresponding accounts submitted by other federal agencies.

Internal Environment

The Department faces impediments to auditable financial statements because of several internal issues. These issues include:

- ensuring capable and competent DoD financial management personnel
- the existence of fraud, waste, abuse, and mismanagement
- the lack of performance measures
- computer security and the Year 2000 (Y2K) issue

Financial Management Personnel

Capable and competent personnel are vital to the efficient and effective operations of the Department's financial management. Comptrollers, deputy comptrollers, budget officers at the Military Departments and the Defense Agencies, and managers of accounting and finance operations at the DFAS are key DoD financial managers. The Department has a plan to enhance the capabilities of its financial managers through the use of programs and training designed to improve their technical skills and core competencies.

Fraud, Waste, Abuse, and Mismanagement

Fraud, waste, abuse, and mismanagement are important issues within the Department's financial management community. Accurate internal control procedures are necessary to rid the Department of these activities and to promote an efficient and effective operational environment for all finance and accounting personnel. To achieve this, the Department is reviewing various opportunities to improve its practices and procedures. Inaccurate internal controls and inefficient processes are areas for potential business process reengineering.

Lack of Performance Measures

Finance and accounting systems often do not include automated indicators that are linked to costs, performance measurements, or other output measurements that are necessary for financial managers' decision-making. The Department is developing relevant performance measurements and gathering the necessary data and intends to implement performance measurements in appropriate areas.

Computer Security and Y2K Issue

Computer security and internal controls are important aspects of a reliable finance and accounting system. The Department experiences an estimated 250,000 computer attacks by computer hackers yearly. DoD computer controls need to provide adequate protection against these attacks for significant financial functions such as payroll, personnel, disbursements, and inventory. In response, the Department continues to enhance its computer security. Systems errors can be fatal to a complex computer system, and the Y2K problem is an issue for all computer systems. The Department has identified its critical financial systems and is applying the necessary resources to ensure these systems are Y2K compliant.

External Environment

The Department faces impediments to auditable financial statements because of several external issues. These issues include:

- burdensome reporting requirements
- new and unproven governmental accounting standards
- the inclusion of information for non-DoD reporting entities
- unresolved audit issues

Burdensome Reporting Requirements

Reporting requirements scheduled to take effect in FY1998 require the disaggregation of data at the sub-organization and program levels. This change presents a significant burden to the Department because of the number of organizations and the vast number of programs executed in a given fiscal year. Specific examples of burdensome reporting requirements are:

- several mandatory reporting requirements and mandatory responding to audit reports
- disaggregate reporting requires the Military Departments and the Defense Agencies to report their operations by over 75 sub-organizations and 500 programs

The Department has many mandated congressional and OMB reporting requirements associated with financial management reform and unqualified auditors' opinions on its financial statements. These include:

- Biennial Financial Management Improvement Plan (Biennial Plan)
- Financial Management Status Report and 5-Year Plan
- Remediation Plan
- OMB Passbacks
- Plan for Resolving Financial Reporting Deficiencies by FY1999

The Department is faced with a mammoth task of improving its financial management policies, procedures, systems, and operations. Existing and new reporting requirements are particularly burdensome and detract from the Department's objective to actually reform and improve its financial management policies, procedures, systems, and operations. In addition, the Department has been inundated with audit reports that require an inordinate amount of resources to prepare and coordinate response. To deal with these reporting requirements, the Department consolidated several of its existing reporting requirements into the Biennial Plan for reporting to the Congress by September 30, 1998.

The disaggregate reporting requirements mandate that the Military Departments and Defense Agencies must prepare stand-alone financial statements. Consequently, the Department must report by over 75 sub-organizations and 500 programs. Current reporting directions also (1) require that production and non-production costs be segregated; (2) require that costs related to the acquisition of (a) federal mission PP&E, (b) heritage assets, and (c) stewardship land be segregated; and (3) suggest that agencies may find it useful to differentiate between transfer payments and administrative costs. These additional reporting requirements will increase the number of reports presented in the Military Department and Defense Agency stand-alone financial statements by several hundred.

New and Unproven Governmental Accounting Standards

The FASAB was established to recommend accounting standards for the Federal Government after considering the financial and budgetary information needs of congressional oversight groups, executive agencies and the needs of other users of federal financial information. The FASAB published several accounting standards which are central to meeting, effectively, the financial management improvement goals of the Chief Financial Officers Act of 1990, as amended. However, a forum for effectively clarifying the accounting guidance contained in FASAB standards has not been established to resolve differences in interpretation that may result in disclaimed audit opinions. Examples of some of the major standards issued by FASAB are listed below:

- imputed financing and expenses
- new accounts established for accrual adjustment
- reporting of prior year actuarial expense
- reporting of progress payments
- lack of general ledger accounting guidance
- new or revised accounting standards that result in material system changes

To deal with the new governmental accounting standards, the Department embarked on a near-term strategic project to revise, modify, and update the DoD FMR. This will incorporate FASAB's SFFAS, as well as its internal form and content guidance, issued annually following guidance issued by the OMB. The intent of updating the FMR is to provide a basis for reprogramming or developing new accounting and reporting systems.

Inclusion of Information for Non-DoD Reporting Entities

The Department does not believe that it is appropriate to include within the Department's agency-wide CFO financial statements, the assets, liabilities, and operating transactions of the Foreign Military Sales (FMS) Trust Fund. While the FMS Trust Fund is managed by the Department on behalf of the Executive Office of the President, these funds belong to foreign governments. The Department recommends that the accounts administered by the Defense Security Assistance Agency (DSAA) and funded by the FMS, not be included in the Department's financial statement preparation.

Unresolved Audit Opinions

Audit opinions rendered on financial statements are intended to indicate the degree of accuracy reflected in the financial statements. Although perhaps unintended, audit opinions frequently are misinterpreted to reflect the quality of stewardship of public funds and assets. A clean opinion is interpreted to reflect favorably upon the management of an agency whereas a qualified, or lesser, audit opinion often is misinterpreted to reflect less favorably on management. DoD management was portrayed less than favorably because of the inconsistent audit procedures and/or unresolved audit issues that resulted in a qualified opinion of the National Defense Stockpile Transaction Fund for FY1996.

REMEDIATION PLAN ANALYSIS

Background

The Federal Financial Management Improvement Act (FFMIA) of 1996 required that each federal agency shall implement and maintain financial management systems that comply substantially with federal financial management systems requirements, applicable federal accounting standards, and the United States Standard General Ledger (U.S. SGL) at the transaction level.

The FFMIA requires that the head of the agency determine whether the financial management systems of the agency comply with the requirements discussed above. Such determination shall be based on a review of the report on the agency-wide audited financial statement, and any other information the head of the agency considers relevant and appropriate.

If the head of the agency determines that the agency's financial management systems do not comply with the requirements of the FFMIA, the head of the agency, in consultation with the Office of Management and Budget (OMB) Director, shall establish a remediation plan. This plan shall include resources, remedies and intermediate target dates necessary to bring the agency's financial management systems into substantial compliance. The remediation plan shall bring the agency's financial management systems into substantial compliance no later than three years after the date a determination is made that the agency's financial management systems are not in compliance. This occurs unless the head of the agency with concurrence of the OMB Director:

- determines that the agency's financial management systems cannot comply with the requirements
- specifies the most feasible date for bringing the agency's financial management system into compliance with the requirements
- designates an official of the agency who shall be responsible for bringing the agency's financial management systems into compliance with the requirements by the date specified

Remediation Plan Discussion

The Department has determined that its financial management systems are not in compliance with the FFMIA's stated requirements. To bring its financial management systems into compliance, the Department is using the resources, remedies, and intermediate target dates described in this Biennial Plan.

Resources The Department is committed to bringing its financial management systems into compliance with the requirements of the FFMIA. Volume II of this Biennial Financial Management Improvement Plan (Biennial Plan), details the corrective actions to achieve compliance.

Remedies The Department is utilizing several remedies to bring its financial management systems into compliance with the FFMIA requirements. These remedies include:

- reduction of the total number of finance and accounting systems
- implementation of the U.S. SGL
- implementation of Global Edit Tables
- establishment of a Year 2000 project
- development of the Biennial Plan

Intermediate Target Dates Some of the major intermediate target dates toward achieving financial management system compliance include:

Objective	Target Date
Activation of the Defense Finance and Accounting Service (DFAS)	FY1991
Establishment of Year 2000 (Y2K) project	FY1991
Identification of 500 standard data elements for the reduced total of finance and accounting systems	September 1996
Initial Global Edit Tables (GET) available	October 1997
Draft publication of the Budget Accounting Classification Code (BACC)	December 1997
Completion of the consolidation of operating locations into the DFAS	September 1998
Completion of the reduction of total finance and accounting systems from 334 to 32	FY2003

Summary The Department has determined that its financial management systems do not comply with the requirements set forth by the FFMIA. To attain compliant systems, the Department is implementing several remedies utilizing applicable and targeted dates, which are discussed in this Biennial Plan.

ANALYSIS OF CURRENT DOD FINANCIAL MANAGEMENT

Scope

In this Biennial Plan, the Department took a comprehensive look at its financial management operations and for the first time, articulated its concept for future operations. This undertaking required coordination from all of the Military Departments and the Defense Agencies in assessing where the Department stands currently in its financial management operations before deciding what it needs to do in order to reach its future concept.

Over the past four years, the Department achieved significant progress in its aim to improve financial management. The Department also realizes that more steps are necessary to make the transition from its current environment to the future environment as delineated by the Concept of Operations.

Current Assessment

The Department's organizational structure in previous years did not support or encourage cross-community functionality or communication. As the Department evolved and implemented joint-Military Service operations, the sharing of financial and other information across the Department became imperative. The Department's organizations and systems, unfortunately, did not easily support the ability to do so. In addition to performing joint operations, the Department also downsized to create a more efficient and effective force, but this also lead to limited investment in a streamlined, up-to-date system architecture.

Non-standard operations and limited investment in modern, flexible systems lead to hundreds of duplicative, stove-piped systems that cannot be easily integrated along with non-standard regulations and procedures. Impediments to the Department's auditable financial statements primarily stem from these systems and related issues. Ultimately, these issues have combined to impair the ability of the Department to gather timely and accurate financial data for management and reporting purposes.

Transition to the Future Environment

Moving the Department from its current to the future environment will be an arduous process, as hundreds of systems and thousands of people are involved. The sheer size of the Department dictates the pace, as it is one of the largest and most complex organizations in the world. If ranked among the top ten Fortune 500 companies, the Department would hold an indisputable first place with annual appropriations one-and-a-half times as much as the revenue of its next closest rival. In fact, the Department's annual appropriations exceed the revenues of four of the top ten combined. In terms of manpower, the Department also has almost twice the number of employees as the top ten Fortune 500 companies combined. The Department's financial management operations annually process $288 billion in disbursements, 1.2 million invoices and 100 million accounting transactions.

The Department envisions an aggressive future environment for its financial management that involves implementing integrated systems, single transaction-driven general ledger data entry, and real-time data access. As the Department's business areas are widely diverse and complex and were not created to adapt easily to the envisioned environment, and considering the overall size of the Department and its activities, change of this magnitude poses a monumental challenge.

To bridge the current environment to the desired future environment described in the Concept of Operations, the Department updated its goals and supporting strategies as discussed in the following section, the Transition Plan. Ongoing initiatives will help the Department carry out these goals and strategies during this transition period, but new initiatives may be necessary as well. The Department's overall ability to achieve its financial management goals, however, is ultimately dependent upon the application of adequate resources, including personnel, time, and funding.